The Case for Taxing Consumption

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This piece points out the benefits of taxing consumption instead of income.
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The Case for Taxing Consumption

Murray Weidenbaum

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A low-saving, slow-growing economy such as the United States would benefit greatly from shifting the national revenue system from taxing income to taxing consumption. That change would provide a powerful incentive to increase the nation's saving and investment and, hence, economic growth and living standards.

Introduction

Public interest in changing the tax system is growing much faster than public understanding of the competing proposals. Democrats and Republicans, liberals and conservatives, all have come up with their favorite nominees for tax cuts — the poor, the middle class, manufacturers, savers, investors, producers of luxury goods, and so forth.

It seems desirable, under these circumstances, to broaden the public debate to go beyond the present inconsistent array of specific proposals to modify slightly the income tax, which is the heart of the existing federal revenue system. Let us consider the most basic change in the government's income structure: abandon the whole idea of taxing income and shift to a consumption tax as the primary federal revenue source.

As we will see, taxing consumption instead of income generates many impacts, mostly desirable. A constant theme among tax reformers is the need for increased incentive for saving, capital formation, and economic growth. In that light, this report examines the pros and

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cons of consumption taxation and also analyzes the major alternative approaches to structuring a new tax of that type.

The governments of most industrialized nations, especially in the European Community, use consumption taxes far more than the United States. While 18 percent of government revenue comes from taxes on consumption in the United States, the comparable figures are 26 percent for Germany, 29 percent for France, and 31 percent for the United Kingdom.

The increasingly international nature of business competition requires updating the American tax system to global realities. There are several basic arguments which economists have offered over the years for shifting the primary base of taxation from income to consumption. It puts the fiscal burden on what people take from society — the goods and services they consume — rather than on what they contribute by working and saving. Thus, saving is encouraged at the expense of consumption. Unlike current consumption, saving makes possible investment in future economic growth. True, problems will arise in setting up a new tax, just as difficulties are encountered with the more limited changes that Congress has been enacting yearly.

There are two major types of consumption taxes. One is a value-added tax (VAT), such as is customary in Western Europe. The second approach is to change the current income tax to an expenditure tax by exempting saving. Unlike selective excise taxes (such as those currently levied on cigarettes and alcohol), a value-added tax is comprehensive. It is paid by each enterprise in the chain of production — manufacturer, wholesaler, and retailer. Duplication is avoided by taxing only the added value that the firm contributes to the goods or services it produces. Essentially, value added is the difference between a business’s sales and its purchases from other companies.

Let us examine the basic argument for encouraging capital formation by means of tax reform.

Promoting Investment and Economic Growth

To many citizens, any discussion of capital formation immediately brings to mind visions of greedy bankers, wealthy coupon clippers, and — to use what is to many a pejorative word — capitalists. Nevertheless, capital plays a pivotal role in providing the basis for the future standard of living of any society. Capital is essential for increasing productivity and thus providing the basis for rising real incomes.

A rising stock of capital is necessary for any growing society.

Educators at times find it amusing when some of their students discover communist-oriented economists writing about the necessity to hold down consumption in the Chinese economy in order to free up the capital resources needed to invest in the future growth of that economy. "Why, they are not even a capitalist society," these students will note in wonderment.

Then the thought will sink in that a rising stock of capital is necessary for any growing society — capitalist (that is, private-enterprise or market-oriented) or other (socialist, communist, and so on). It is really a basic matter of how much we want to eat, drink, and be merry today, and how much we want to set aside for tomorrow. Boiled down to its fundamentals, assuring an adequate flow of saving and investment is little more than demonstrating a proper concern for the future.

A slow pace of capital formation in the United States is especially troublesome at a time of heightened global competition, when modern, state-of-the-art machinery and equipment are necessary to match foreign firms with low-wage structures.
Any doubt about the tendency of the U.S. tax system to be biased in favor of consumption and against saving can be resolved quickly with a very simple example. Consider three factory workers, A, B, and C, each of the same age, with the same work experience and size of family, and with the same compensation. Mr. A regularly spends what he earns, no more and no less. Mrs. B, a saver, deposits a portion of her paycheck into a savings account each week. Mr. C not only spends everything he earns but also borrows to the hilt, having bought as expensive a house as he could obtain financing for.

It is interesting to compare the differential tax burden of these three workers. Clearly, Mrs. B, the saver, will have the highest tax bill, for she pays taxes on her wages as well as on the interest that she earns on her savings account. Mr. C winds up with lowest tax bill, as he receives a tax deduction for the interest he pays on his large mortgage. Actual practice includes many variations in the tax treatment of specific financial transactions. Yet, for the average citizen, the existing personal income tax structure favors consumption over saving. In addition, many of the government spending programs — such as welfare and food stamps — operate with a similar effect.

Let us assume that A, B, and C all get laid off at the same time and that none of them obtains a new job. Mr. C, the big spender, and Mr. A, the pay-as-you-go man, will quickly be eligible to receive welfare, food stamps, and related benefits. The last to qualify for federal assistance will be Mrs. B, the big saver. Unlike the good Lord, the feds do not seem to help those who help themselves.

Changing the Tax Structure

All this is no justification for returning to the revenue structure of 1986 and prior years, although incentives for saving and investment were greater than they are today. Surely, the elimination of many tax shelters was a definite plus for the efficiency of the economy, because so many of them had financed investments in uneconomical projects whose major purpose was to generate tax benefits.

Nor is there a need to jump to the conclusion that the investment incentives available under the tax structure of the early 1980s provided the most cost-effective way of encouraging capital formation. Nevertheless, one important decision for the 1990s is to consider moving to a tax system that is more favorable to saving and investment, the keys to economic growth and rising living standards.

Many analysts believe that it is fairer to tax people on what they take from society, rather than on what they contribute by working and investing.

A fundamental tax change would be to substitute consumption for income as the basis for computing tax liabilities. A consumption-based tax has been described by the American Council for Capital Formation as the next frontier in U.S. tax policy.

Although the subject has only recently gained public attention, for years economists have debated the respective merits of income and consumption as the basis for taxation. The United States uses consumption taxes to a far lesser degree than most other developed Western nations. In 1989, the 24 members of the Organization for Economic Cooperation and Development obtained an average 34 percent of their revenue from taxes on consumption. For the United States, the ratio was 15 percent. Japan has since increased its dependence on consumption taxation.

Many analysts believe that it is fairer to tax people on what they take from society, rather than on what they contribute by working and
investing. In the nineteenth century, classical economist John Stuart Mill made this point in advocating the exemption of saving as part of a "just" income tax system. In the 1940s, American economist Irving Fisher argued that the income tax involved double taxation of saving and distorted the choice of individuals in favor of consumption. Thus, not only is the income tax unjust, but it encourages consumption and leisure at the expense of thrift and enterprise.

The U.S. Treasury actually proposed a "spending tax" in 1942 as a temporary wartime measure to curb inflation. The proposal was quickly rejected by Congress. A major argument against such a tax — then and now — is that the exemption of saving would favor the rich, since they are better able to save large portions of their incomes. Some believe that this would lead to greater concentrations of wealth in the hands of a few. Proponents of a consumption tax respond that it can be made as steeply progressive as desired. Moreover, the recent trend in income taxation in the United States has been away from progressive and toward a flatter, more proportional revenue structure. The 1981 and 1986 tax statutes are striking cases in point.

Another objection to the consumption base is that it would favor the miser over the spender-thrift, even when both have similar spending power or ability to pay. The response offered to this argument is that consumption uses up the resources available to the nation, while saving adds to these resources. Thus, people should be taxed on what they take out of the society's pool of resources, not on what they put into it.

Tax experts have devised, and criticized, a variety of specific consumption-based taxes. No consensus has yet been reached on the details. It is likely that three interrelated clusters of issues will receive increased public attention in the 1990s: (1) the desirability of a tax on consumption, (2) the specific form that it should take ("top down" or "bottom up"), and (3) whether it should replace or augment an existing tax.

**A Consumption Tax**

In practice, much of the impact of shifting to a consumption tax base would depend on how the tax was structured. The two major alternatives are consumption taxes levied on total purchases (top down) and value-added taxes collected on individual sales (bottom up). In theory, the base of the two taxes is the same (the value of goods and services purchased) and the yields could be very similar.

Consumption taxes would be collected much as income taxes are, levied directly on the taxpayer. The annual taxpayer return would continue to comprise the heart of the collection system, containing exemptions and deductions, as at present. However, one major change would be instituted: the portion of income that is saved would be exempt from taxation.

Figure 1 is a hypothetical example of a "short form" version of a consumption tax return. It shows how the difficult bookkeeping requirement to tally all consumption outlays could be structured. The illustrative tax form is based on the notion that income equals consumption plus saving. Thus, consumption can be readily estimated, indirectly but accurately, merely by deducting saving from income (and taxpayers are used to developing estimates of their incomes). That new schedule would include changes in bank balances and in holdings of bonds, stocks, and similar investment assets.

A tax on consumption could be made as progressive as any income tax by adjusting the
Figure 1

Illustrative Consumption Tax Return

<table>
<thead>
<tr>
<th>Receipts</th>
<th>Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Wages, salaries, tips, etc.</td>
<td></td>
</tr>
<tr>
<td>2. Dividends</td>
<td></td>
</tr>
<tr>
<td>3. Interest</td>
<td></td>
</tr>
<tr>
<td>4. Rents and royalties</td>
<td></td>
</tr>
<tr>
<td>5. Pensions and annuities</td>
<td></td>
</tr>
<tr>
<td>6. Net receipts of sole proprietorships</td>
<td></td>
</tr>
<tr>
<td>7. Withdrawals from partnerships</td>
<td></td>
</tr>
<tr>
<td>8. Receipts from:</td>
<td></td>
</tr>
<tr>
<td>a. sales of financial assets</td>
<td></td>
</tr>
<tr>
<td>b. gifts and bequests</td>
<td></td>
</tr>
<tr>
<td>c. insurance</td>
<td></td>
</tr>
<tr>
<td>9. Net decrease (if any) in bank accounts</td>
<td></td>
</tr>
<tr>
<td>10. Total (add lines 1 through 9)</td>
<td></td>
</tr>
</tbody>
</table>

Savings

| 11. Purchases of financial assets |         |
| 12. Capital contributed to partnerships |         |
| 13. Net increase (if any) in bank accounts |         |
| 14. Other investments |         |
| 15. Total (add lines 11 through 14) |         |
| 16. Gross Consumption |         |
| (subtract line 15 from line 10) |         |

Deductions

| 17. A. Itemized deductions |         |
| 18. Federal taxes paid during the year |         |
| 19. Total (add lines 17 and 18) |         |
| 20. Net Consumption (subtract line 19 from line 16) |         |
| 21. Exemptions |         |
| 22. Taxable Consumption |         |
| (subtract line 21 from line 20) |         |

For a while, the United States was moving toward a consumption tax, albeit indirectly and in modest steps. The establishment of independent retirement accounts (IRAs) enabled many federal taxpayers to defer paying taxes on amounts saved and invested in an IRA (up to $2,000 a year). Also, the first $100 of dividends per taxpayer was exempt from income taxation. The 1986 tax law, however, sharply cut back on IRAs and eliminated the dividend credit.

A Value-Added Tax

A consumption tax, as shown above, can be calculated via a "top down" approach, building on the records that are already available to provide the data needed for the collection of corporate and personal income taxes. In contrast, a value-added tax (VAT) represents a very different way of collecting a general tax on consumption, focusing on the sales to consumers by individual companies. In total, a VAT should be equivalent in yield to a single-stage sales tax levied at the retail level. It is, in effect, a sophisticated and comprehensive sales tax which avoids the double counting otherwise inevitable when the same item moves from manufacturer to wholesaler to retailer.

Essentially, a firm's value added is the difference between its sales and its purchases from other firms. As shown in Table 1, value added can also be estimated by adding labor and capital inputs supplied by the firm itself — represented by wages and salaries, rent and interest payments, and profit.

Reasons for Favoring a VAT

Proponents of the VAT contend that it is economically neutral, because ideally it would
Advocates of the value-added tax also point out that, in contrast to an income tax, there is no penalty for efficiency and no subsidy for waste. Moreover, the VAT is neutral between incorporated and unincorporated businesses and, theoretically, even between public and private enterprises. By focusing on consumption, it avoids a double tax burden on the returns from capital. This tax starts off with no exclusions or exemptions and thus, at least initially, provides a broader and fairer tax base, one that the underground economy will have more difficulty evading. Consumption taxes such as the VAT are levied on the returns to labor (wages and salaries) equally with the returns on capital (rent, interest, and profits).

The VAT has become one of the revenue workhorses of the world.

Another argument in favor of U.S. adoption of a value-added tax is that so many other nations have adopted this form of revenue. It fits in better than other taxes with the growing international character of production. The VAT has become one of the revenue workhorses of the world. Virtually every important country in Europe imposes the tax and it has spread throughout the Third World. The members of the European Common Market have used VAT taxation since the late 1960s or early 1970s. In 1989, Japan imposed a broadbased 3 percent sales tax.

Unlike the situation in the United States, the adoption of a tax on value added was true reform in Western Europe. Value-added taxes typically replaced an extremely inefficient form of consumption tax that was already in place, a cascading sales or turnover revenue system. Those latter taxes apply to the total amount of a firm's sales rather than only to its value added. Sales taxes, thus, would be paid over and over again on the same items as they moved from firm to firm in various stages of the production process.
and distribution process. Such cascade-type taxes favored integrated firms (who could legally avoid one or more stages of the tax), but they severely discriminated against independent companies who operate at only one phase of the production process.

An added, widely cited reason for adopting a VAT is the anticipated foreign trade benefits. Unlike an income tax, a sales-based tax can be imposed on goods entering the country and rebated on items leaving—supposedly encouraging exports and discouraging imports. Thus, at first blush, a VAT would seem to help reduce this nation's presently large deficit.

However, most economists believe that fluctuations in exchange rates would largely offset these initial effects and result in little change in the balance of trade.

Reasons for Opposing a VAT

Opponents of a value-added tax offer an extensive list of shortcomings. They contend that a VAT, as in the case of any consumption-based revenue source, is inherently regressive—that those least able to pay face the highest rates. That regressivity can be softened by exempting food and medicine or by refunds to low-income taxpayers, but such variations make the collection of the tax more complicated. They also provide opportunity for people in the underground economy to avoid paying taxes.

Because the VAT is included in the price of purchases, it registers in all of the price indices and, hence, exerts an inflationary force on the economy. The counterargument is that this is only a one-time effect, occurring when the tax is enacted or increased. However, there would be secondary effects resulting from the operation of automatic escalators in wage and price agreements. That inflationary impact could be offset by appropriate changes in monetary policy, albeit at times with an adverse effect on the levels of production and employment. Opponents also charge that a VAT would invade the area of sales taxation, traditionally reserved for state and local governments. However, states and some localities, have come to rely on income taxes despite heavy use of the same tax base by the federal government.

Turning to the administrative aspects, imposition of a value-added tax in the United States would require establishing a new tax-collection system by the federal government and new recordkeeping on the part of taxpayers. The Treasury Department, based on European experience, believes it would need 18 months after enactment to begin administering a VAT.

A variety of approaches has been suggested for collecting the new tax. The simplest is the credit method (see Table 2). Under this approach, the tax is computed initially on a company's total sales and the firm is given credit for the VAT paid by its suppliers. To a substantial degree, such a VAT would be self-enforced. Each company would have a powerful incentive to ensure that its suppliers paid their full share of the tax, because any underpayment would have to be made up by the next firm in the chain of production and distribution.

In practice, the collection of the VAT may not be as simple as shown here. That would be the case if certain transactions were exempted (such as food) and if nonprofit institutions and government enterprises were treated differently from business firms. Exemptions are no minor matter in terms of the administrative complexity that they generate. In France, a long and extensive debate occurred over whether or not Head and Shoulders anti-dandruff shampoo was a tax-exempt medicine or a cosmetic subject to the full VAT.
Table 2
Computing the VAT Using the Credit Method

<table>
<thead>
<tr>
<th>Item</th>
<th>Raw Materials Producer</th>
<th>Manufacturer</th>
<th>Wholesaler</th>
<th>Retailer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales of output</td>
<td>$100</td>
<td>$500</td>
<td>$800</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less purchases</td>
<td>0</td>
<td>100</td>
<td>500</td>
<td>800</td>
</tr>
<tr>
<td>Value added</td>
<td>$100</td>
<td>$400</td>
<td>$300</td>
<td>$200</td>
</tr>
<tr>
<td>Tax on total sales</td>
<td>$10</td>
<td>$50</td>
<td>$80</td>
<td>$100</td>
</tr>
<tr>
<td>Credit on purchases</td>
<td>0</td>
<td>10</td>
<td>50</td>
<td>80</td>
</tr>
<tr>
<td>Tax liability</td>
<td>$100</td>
<td>$400</td>
<td>$300</td>
<td>$200</td>
</tr>
</tbody>
</table>

Note: Assumes 10 percent VAT on a consumption basis.

There is a great variation in the VAT rates within the various countries that use it. In Western Europe, the standard VAT rate ranges from 12 percent in Spain to 25 in Ireland, although some luxury items are taxed at higher rates. However, Spain taxes some items at as low as 6 percent and Ireland’s VAT on occasion is down to 2.4 percent. The United Kingdom has a zero tax on books and food. The future minimum VAT rate in the European Community has been set at 15 percent.

Macroeconomic Effects

On the basis of 1990 levels of economic activity, a 5 percent VAT would yield in the neighborhood of $100 billion in federal revenue (depending on the coverage of the tax). If the VAT is considered to be an additional source of federal revenues, fiscal flows of such magnitude likely would generate a variety of other impacts on the economy. For example, these estimates of the yield of the VAT assume that the Federal Reserve will follow an accommodating monetary policy, with a somewhat inflationary effect.

Because the withdrawal of such substantial amounts of purchasing power would act as a depressant on the economy, a tax of that magnitude might be phased in over a period of time — or offset by reductions in existing income taxes. One econometrics analysis concludes that the economy would grow about 1 percent more slowly for each 1 percent of VAT levied and that inflation would be 1-1/2 to 2 percent higher during an initial adjustment period.

In policy terms, the institution of a new tax in the 1990s should not be viewed in isolation but in comparison to likely alternatives:

- Foregoing desirable increases in government programs;
- Increasing income tax rates; or
- Continuing with high levels of deficit financing.

Each of these other approaches to the budget problem would be accompanied by substantial burdens or costs, although they would differ from those generated by the imposition of a consumption-based tax such as a VAT. Foregoing increases in education, infrastructure, and research and development might have adverse consequences on the prospects for economic growth. Reversal of the 1980s trend toward lower marginal income tax rates would reduce the incentives to work, save, and invest. Continued high levels of deficit spending would bring their own set of drawbacks, ranging from high real interest rates to upward pressure on the dollar and thus on the foreign trade deficit.

Value-Added Tax as a Substitute

The substitution of a value-added tax for all or portions of existing income and payroll taxes is also a possibility. In the recent past, several
proposals have been made to make the VAT a part of the U.S. tax structure.

In 1980, Representative Al Ullman (D-Ore.), then Chairman of the House Ways and Means Committee, introduced a comprehensive revenue bill. It provided for individual and corporate income tax rate reductions, liberalized depreciation rules, expanded retirement savings provisions and reduced Social Security taxes, all of which were offset by a 10 percent tax applied to a moderately narrow value-added base (which excluded food, housing, medical care, farmers, fishermen, mass transit, interest, and exports). Ullman's defeat for reelection soon after dampened the enthusiasm for a VAT for some time.

In 1985, Senator William Roth (R-Del.) proposed a variation of the VAT called a Business Transfer Tax (BTT). It would be a way in which companies could pay for their Social Security tax liabilities. The base for the new tax would be similar to the earlier Ullman proposal. His bill also called for using the net revenues of his consumption-style tax (after the Social Security credit) to reduce individual tax rates and to provide increased individual saving incentives. In 1986, Senator Roth outlined explicit income tax rate reductions and investment-related provisions which would be funded by revenues from an eight percent BTT (after the Social Security credit) applied to a much broader base than his earlier proposal.

In 1992, former California Governor Jerry Brown proposed a 13 percent value-added tax to accompany the move to a flat income tax at the same rate.

Conclusions

On balance, it seems that a "top down" consumption tax would achieve most of the benefits intended for a VAT with few of the shortcomings of that "bottom up" type of revenue measure. Converting the income tax to a consumption tax — unlike adopting a new tax on value added — does not require setting up an additional collection system. Nor is it regressive or inflationary. Unlike a VAT, transforming the existing income tax does not provide the federal government with a new revenue source; therefore, the public sector is not likely to grow as rapidly.

In contrast, a value-added tax becomes complicated if an effort is made to soften its regressivity by exempting certain categories of expenditures or taxing them at lower rates (e.g., food, medicine, education).

Converting the income tax to a consumption tax — unlike adopting a new tax on value added — does not require setting up an additional collection system.

It is not surprising that politicians in many countries favor sales-type taxation on the assumption that the best tax is a hidden tax. The fact is that "bottom up" sales taxes such as a VAT are rarely identified separately, and the purchaser merely pays a combined product-and-tax price. That type of consumption tax thus finds business firms acting as the middleman (or woman) between government and the consumer. Many companies marketing consumer products fear that the higher prices resulting from imposing a VAT will reduce their sales and profits. Conversely, companies selling capital equipment and business services tend to take a more sympathetic attitude toward this form of government revenue, which would lighten the tax burden on their customers and, hence, tend to expand their markets.

Changing the income tax to a comprehensive consumption tax, in contrast, would not be shielded from the knowledge of the taxpayer and is not likely to generate such differential reactions. In any event, the shift in emphasis in U.S. taxation from income to consumption should on balance generate positive results, especially in helping to move the economy to a
more rapid expansion path and, thus, enable the American people to enjoy a higher living standard.

References


